IN THE

Supreme Court of the United States

OCTOBER TERM—1947

No. 384

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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The writ should be denied because:

1. The decision below is not in conflict with the decision of any other Circuit Court but, on the contrary, cites and follows the only other cases in the Circuit Courts that have considered the question presented, to wit: the determination of the earnings and profits of an installment seller under §115(l) I. R. C.

2. The reasons urged by the Government for granting the writ are without substance.

Preliminary Statement.

The taxpayer sold real estate on the installment basis, receiving in payment therefor cash and promissory notes secured by a lien on the land. The taxpayer, being on the

accrual basis, carried on its books as receivables the installment obligations received from such sales (R. 31). Income from the sales was reported for income tax and excess profits tax purposes under the installment provisions contained in §44(a) I. R. C. (R. 31). The question is whether, in determining the taxpayer's earnings and profits as of the beginning of a taxable year, the profit from installment sales made in prior years is includible in full in such earnings and profits. The question arises in connection with the determination of the taxpayer's invested capital credit under the excess profits tax. The deficiency in controversy is $1,708.53 (R. 30).

If the taxpayer had not elected to report the gains from such sales on the installment basis, the full amount of such gains would have been taxable in the years the sales were made (Reg. 111, §§29.44-3, 29.44-4) and, as the court below pointed out (R. 53), the Commissioner would then concede that the profits from such sales were fully includible in the taxpayer's earnings and profits at the dates involved even though a part of such gains remained to be collected. There is, therefore, no objection to the includibility of such profits on the ground that they had not been collected, *i.e.*, that they were represented by installment obligations payable in the future.

The sole question is, therefore, whether the uncollected profits from the installment sales, represented by installment obligations on hand at the dates involved, should be excluded from taxpayer's earnings and profits because taxpayer, having availed itself of the privilege of reporting such profits on the installment basis, had not previously paid a tax thereon. The court below held not. In so holding the court below (by a majority consisting of Sibley and Waller, JJ.) followed its own prior decision (rendered by a majority consisting of Hutcheson and Russell, JJ.) in *Comm'r* v. *Shenandoah Company*, 138 F. (2d) 792 (1943).

Judge Holmes dissented in the present case and in the *Shenandoah* case.

The *Shenandoah* case is directly in point. It was squarely based on §115(1) of the Code, as the quotation at page 14 below shows. The petition for the writ agrees (pp. 8-11) that §115(1) is controlling on the question here presented. Section 115(1) (enacted by §501(a) of the Second Revenue Act of 1940) provides as follows:

> "EFFECT ON EARNINGS AND PROFITS OF GAIN OR LOSS AND OF RECEIPT OF TAX-FREE DISTRIBUTIONS.—The gain or loss realized *from the sale or other disposition* (after February 28, 1913) *of property* by a corporation—
>
> (1) for the purpose of the computation of earnings and profits of the corporation, *shall be determined,* except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but
>
> (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, *shall be determined* by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.
>
> Gain or loss so realized *shall* increase or decrease the earnings and profits *to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.* * * *"
> (Italics added).

The Government contends, as it did in the *Shenandoah* case, that the part of the gain from installment sales which

has not previously been taxed is not includible in earnings and profits under the above provision on the theory that such part has not been "recognized in computing net income under the law applicable to the year in which such sale or disposition was made." This is the only specific assignment of error. (Of course, if this contention were correct, the gains in question would *never* be includible in the earnings and profits of the seller because recognition of such gains under the law of any year *other than the year of sale* would not meet the statutory test contained in §115(l).)

The sole argument advanced by the Government in the court below in support of its contention was that gains are not "recognized" until a tax is payable thereon. That argument is not expressly made in the petition for the writ, which merely begs the question throughout by *assuming* that recognition and taxation are synonymous terms. The Government's position is plainly unwarranted. The numerous differences between recognition and taxation are discussed in point 2(b) below (pp. 9-13).

Reasons for Denying Writ.

1. The decision below is not in conflict with the decision of any other Circuit Court but, on the contrary, cites and follows the only other cases in the Circuit Courts that have considered the question presented.

The Tax Court's decision in the present case (7 T. C. 669, August 30, 1946) was rested entirely upon the Tax Court's prior decision in *Kimbrell's Home Furnishings, Inc.*, 7 T. C. 339 (July 11, 1946) which was afterwards reversed by the Fourth Circuit Court of Appeals in a decision handed down on February 3, 1947. *Kimbrell's Home Furnishings, Inc.* v. *Comm'r*, 159 F. (2d) 608.

Apart from the decision of the Fourth Circuit in the *Kimbrell's* case, the only other decision which has considered the effect of §115(l) on the question here presented is the *Shenandoah* case, *supra* (138 F. (2d) 792), decided by the Fifth Circuit in 1943. The *Shenandoah* case was cited and followed by the Fourth Circuit in the *Kimbrell's* case, and the *Shenandoah* and *Kimbrell's* cases were cited and followed by the court below.

Neither the Tax Court's decision in the present case nor its decision in the Kimbrell's case contained any reference to §115(l) of the Code which, as conceded by the Government, is controlling on the question presented. Furthermore, in the only other case decided by the Tax Court on this issue, no reference was made to §115(l). *May, Stern & Co.*, 7 T. C. 1488 (memorandum opinion reported in 5 T. C. M. 806). That case, which was decided by the Tax Court subsequent to its decision in the present case, was also rested entirely on the authority of the Tax Court's prior decision in the *Kimbrell's* case, so far as the question here presented was involved.

After the reversal of the *Kimbrell's* case by the Fourth Circuit on February 3, 1947, the petitioner in the *May, Stern* case moved the Tax Court for reconsideration of its opinion in that case. By order dated March 25, 1947, the Tax Court granted the motion for reconsideration and directed briefs to be filed. In granting such motion the Tax Court noted that its decision in the *Kimbrell's* case had been reversed and that its previous decision in the *May, Stern* case had been rested solely on the authority of the *Kimbrell's* case. The *May, Stern* case has since been resubmitted to the Tax Court on briefs covering this issue and that court, which had not referred to §115(l) in any of its prior opinions on the subject, now has under consideration for the first time the question here presented, viz., the in-

cludibility in earnings and profits under §115(l) of profits from installment sales upon which no income or excess profits tax has been paid.*

The Commissioner did not ask this Court to review either the *Shenandoah* case or the *Kimbrell's* case. Since the court below merely followed those cases and since there have been no other or conflicting decisions rendered in the lower courts, the customary ground for certiorari is absent.

2. The reasons urged by the Government for granting the writ are without substance.

(a) The decision below is of relatively small importance in the orderly administration of the tax laws.

The petition urges that the decision below is of importance in the administration of the tax laws (1) because it "affects the excess profits tax liability of all corporations that reported income on the installment basis", and (2) because it would effect a change in the law with respect to the determination of earnings and profits for dividend purposes (Petition, p. 8). Neither contention is sound.

The decision below does not affect the excess profits tax liability "of all corporations that reported income on the installment basis".** In the first place, it could affect only installment sellers who computed their excess profits tax by use of the invested capital credit. Many installment sellers used the income credit and the decision below could have no effect upon their excess profits tax liabil-

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* Any appeal from the decision to be rendered by the Tax Court in the *May, Stern* case would lie to the Third Circuit Court of Appeals. The amount of tax involved in this issue in the *May, Stern* case is $38,798.65.

** The excess profits tax was enacted by §201 of the Second Revenue Act of 1940. It was repealed with respect to all taxable years beginning after December 31, 1945 by §122(a) of the Revenue Act of 1945.

ities. In the second place, many, if not most, installment sellers who did use the invested capital credit made the election provided by §736(a) I. R. C. (enacted by §222(d) of Revenue Act of 1942) authorizing such taxpayers to elect to compute (for excess profits tax purposes) their income from installment sales on the accrual basis in lieu of the basis provided by §44(a). The present case did not involve an election under §736(a) and is therefore not controlling in the case of taxpayers who made such an election. (See the decision of the Fourth Circuit in the *Kimbrell's* case, *supra* (159 F. (2d) 608), holding, in the case of a taxpayer which made the election under §736(a), that its uncollected profits from installment sales were includible in its earnings and profits for the purpose of the invested capital credit. As pointed out above, no application for certiorari was made by the Government in that case.)

The decision below does not effect a change in the law with respect to the determination of earnings and profits for dividend purposes. The question of the includibility of uncollected profits from installment sales in earnings and profits for the purpose of dividend distributions was decided by the Fifth Circuit in 1943 in the *Shenandoah* case, *supra* (138 F. (2d) 792). The court held that such profits were includible for that purpose and based its decision upon the provisions of §115(l). From the standpoint of taxing distributions to stockholders, this holding was favorable to the Government in that it prevented non-taxable distributions by installment sellers out of uncollected gains. No application for certiorari was made in the *Shenandoah* case. Under these circumstances there is clearly no merit in the Government's contention that the decision below, which

simply followed the *Shenandoah* case, will require it to reopen the tax liabilities of stockholders for prior years.

The further statement in the petition (footnote 2) that "administrative practice has treated distributions as not constituting dividends where they were paid out of gains which had not yet been recognized by the corporation for its income tax purposes" (meaning by this, gains which had not been subjected to tax) is also incorrect. The regulations (Reg. 111, §29.115-3) provide that "Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under Section 22(a)." What has been excluded from earnings and profits, as a matter of administrative practice, is gain that has not been recognized under §112. The exclusion of such gains is now required by §115(l). But neither §115(l) nor administrative practice excludes gains from earnings and profits simply on the ground that they have not been subjected to tax.

In the court below the Commissioner was obliged to concede that there were numerous instances in which gains that had not been taxed, and losses which were not allowable as deductions, entered into the computation of earnings and profits. Among the instances of this kind listed in the Government's brief below (pp. 30, 47-8) were: increment in value of property acquired prior to March 1, 1913 realized upon subsequent sale of the property, losses disallowed under §24(b) on sales to a controlling stockholder, capital losses to the extent not allowed as a deduction, exempt income, and capital gains realized in the United States by a foreign corporation not engaged in business here. These instances show that there is no basis for

the Government's claim that, under administrative practice, gains which have not entered the computation of a corporation's taxable income are excluded from its earnings and profits.

(b) The decision below is in accord with §115(l) and the Treasury Regulations promulgated thereunder.

There is no foundation for the Government's assumption that only gains which have been taxed are "recognized" within the meaning of §115(l).

(i) The Government's position would result in the absurdity, pointed out above (p. 4), that gains from installment sales to the extent not taxed in the year of sale could never be included in earnings and profits. Section 115(l) requires not only that gain be recognized but that it be recognized under the law of the "year in which such sale or disposition was made". This means that unless the gain is recognized in the year of sale, as the court below held that it was, it can never enter into the computation of earnings and profits. Even if the gain were recognized under the law of some year other than the year of sale, that would not satisfy the requirement of the statute. Therefore, the only sensible construction that can be placed upon the statute is the one placed upon it by the court below.

(ii) The full amount of the gain from an installment sale must be regarded as recognized in the year of sale for the reason, if for no other, that under the express provisions of §44 the full amount of such gain enters into the computation of the fraction of each cash payment which is to be reported by the seller as taxable income (see Reg. 111, §29.44-1).

(iii) The Government's contention is denied by the the very regulations which the Commissioner has promul-

gated under §115(l), by T. D. 5024, 1940-2 C. B. 110. These regulations provide (Reg. 111, §29.115-12):

> "As used in this subsection [§115(l)] the term 'recognized' has reference to *that kind* of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss * * * may be recognized *though not allowed as a deduction* (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but *the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss.* * * * The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) *as distinguished from the realized gain or loss used in computing net income.*" (Italics added.)

Example 2 in this regulation is a case where "for the purpose of computing net income the gain is only $800" but where, by the same transaction, total earnings and profits are "increased by $1,900." Although $1,100 of the gain is not taxed, it is nevertheless held to be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made," and, therefore, includible in earnings and profits under §115(l).

These regulations confirm that gain or loss is recognized within the meaning of §115(l) if, in the year of sale, it was of the kind recognized under §112 of the Code or a corresponding provision of the prior revenue acts, and that if gain or loss is so recognized it enters into the determination of earnings and profits regardless of whether it entered into the computation of taxable income.

(iv) The Government's contention is inconsistent with the statutory definition of "recognition" which the Code makes applicable "for the purposes of this chapter", *i.e.*, Chapter 1, containing §115(l). Section 111(c) provides:

> "(c) RECOGNITION OF GAIN OR LOSS.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112."

Section 112(a) provides:

> "(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section."

None of the exceptions contained in §112 to the general rule stated in §112(a) are material here; as the petition agrees (footnote 3). Therefore, under the statute the full gain from installment sales is recognized in the year of sale.

Despite the all-inclusive provisions of §112(a), the Commissioner urges that §§44 and 111(d) are non-recognition provisions in so far as they authorize the return of gains from installment sales in a year other than the year of sale. But these sections do not purport to be recognition sections, nor do they contain anything which in substance or effect provides that an installment sale, to the extent of the uncollected profits thereon, is not recognized. Recognition simply means that gain or loss is deemed to have occurred. As Mr. Justice Jackson said in *Comm'r* v. *Wheeler*, 324 U. S. 542, 546 (1945):

> "Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly

> provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§112, 113."

It is clear that §§44 and 111(d) do not treat installment sales as transactions in which "the economic changes are not definitive enough to be given tax consequences."

Only if recognition were deemed to be equivalent to taxation could §§44 and 111(d) be regarded as non-recognition sections. That recognition and taxation are not equivalent is demonstrated by the existence of numerous instances, referred to at page 8 above and also in the regulation quoted at page 10 above, in which gain is recognized within the meaning of the statute although not included in taxable income.

The Government made no attempt below to reconcile its position with the existence of cases in which untaxed gain is admittedly "recognized" under the statute other than to say that they were "exceptions". But the fact that all these so-called "exceptions" exist disproves the Government's claim that recognition and taxation are equivalent.

(v) In 1941, the year following the enactment of §115(l) and the promulgation thereunder of the regulations now contained in §29.115-12 of Reg. 111, quoted at page 10 above, the Commissioner (by T. D. 5059, 1941-2 C. B. 125) added the following provisions to another section of the regulations (now §29.115-3 of Reg. 111):

> "* * * the amount of the earnings or profits in any case will be dependent *upon the method of accounting properly employed in computing net income.* For instance, * * * a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; * * *." (Italics added.)

Since the regulation amended was by its terms applicable only to the determination of the earnings and profits of a given period (as distinguished from total earnings and profits), the above-quoted provisions do not, strictly speaking, apply in a case involving determination of total earnings and profits for the purpose of computing a corporation's equity invested capital. Beyond this, however, the above-quoted provisions, in so far as they would require gain from an installment *sale* to be returned for taxation before inclusion thereof in earnings and profits, are in direct conflict with §115(l) and therefore cannot be supported.* The provisions of §115(l) that gains *from sales* shall increase earnings and profits "to, but not beyond, the extent to which" such gains are recognized under the law of the year of sale, are exclusive and permit of no implied exceptions based on accounting practice, taxation or otherwise.

(c) The decision below in no way conflicts with *Comm'r v. Wheeler*, 324 U. S. 542 (1945).

The petition for the writ asserts (pp. 12-13) that the *Wheeler* case in principle overruled the *Shenandoah* case upon which the lower court relied. This argument was also made by the Government to the Fourth Circuit in the *Kimbrell's* case and was rejected by that court which cited and followed the *Shenandoah* case. The argument was accepted by Judge Holmes in the court below, but without reasons given. (Judge Holmes had also dissented in the *Shenandoah* case.)

The contention is based, not upon any inconsistency between the decisions, but upon a complete and obvious misstatement of the grounds of the decision in the *Shenandoah* case, to wit, that such decision was based upon a

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* The above-quoted provisions also conflict with the provisions of the regulations, quoted at page 10 above, which expressly deal with the effect of §115(l) on earnings and profits.

line of cases, such as *Comm'r* v. *F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3d, 1939), which were overruled by the *Wheeler* case. The *Shenandoah* case did *not* purport to follow such line of cases. On the contrary, the *Shenandoah* case recognized that such cases were no longer authoritative in view of the enactment of §115(l). The sole question considered in the *Shenandoah* case was whether uncollected profits from installment sales were recognized within the meaning of §115(l). The Commissioner contended, as here, that they were not because no tax had been paid thereon. The court rejected that argument, saying, per Hutcheson, Cir. J. (p. 794):

> "* * * Nothing in Sec. 501 [§115(l) I. R. C.] limits, or purports to limit, earnings and profits from sales of property to those which were 'recognized' by the taxpayer as taxable to him in the year in which the dividend was declared. It merely limits them to such as were 'recognized', in computing net income, under the law applicable to the year in which the sales were made, and it stands conceded that the Revenue Act of 1936, the law applicable, clearly recognizes the receipts in this case as gains, and, but for the option to defer payment of taxes on them it would have subjected the taxpayer to taxes on them in the year of their receipt. *All that Section 501 [§115(l)] does, all that it was intended to do, is to limit usable earnings and profits from sales of property to that portion of the gain realized which is taxable, and there is nothing in it which restricts such usable profits to those gains only which are returned for taxation, in the year of their realization.*" (Italics added.)

In the *Wheeler* case the corporation involved had sold certain property and realized a gain thereon which was recognized under §112. The stockholders contended that the gain was not includible in earnings and profits for the

purposes of determining whether a distribution to them was a taxable dividend. Their contention was based upon the fact that from an accounting standpoint the corporation, instead of having gain from the sale, had sustained a loss. They relied upon the *Young* case, *supra*, and similar lower court cases holding that earnings and profits were to be determined in accordance with accounting concepts.

This Court considered the question independently of §115(l), which had been enacted after the year involved, and held that the gain was to be included in earnings and profits to the extent recognized under §112, and that it was immaterial that from an accounting standpoint the sales had resulted in a loss. In so holding this Court said, per Mr. Justice Jackson (pp. 546, 547):

> "But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts either. * * * as the Commissioner's regulation directs: gains and losses are to be brought into earnings and profits at the time and 'to the extent' that they are recognized under §112."

This being the sum and substance of the *Wheeler* case, how can it be seriously urged that the *Wheeler* case in principle overruled the *Shenandoah* case, which likewise held that gains from sales, to the extent recognized under §112, were to be included in earnings and profits.

(d) Decisions rendered under the Revenue Act of 1918 are clearly distinguishable because such act contained no provision comparable to §115(l).

The petition asserts (pp. 14-15) that the decision below is in conflict with the decisions of other circuits under a "corresponding provision" of the Revenue Act of

1918. The provision referred to was a provision for the inclusion in invested capital of "paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year" (Rev. Act 1918, §326(a)(3)). The 1918 Act contained no provision corresponding to §115(l), which the Government concedes is the controlling section here. Consequently the question here involved was not raised in or decided by the earlier cases.

The cases decided under the 1918 Act took the view that uncollected installment profits were not includible in earnings and profits because they were "earnings" of the year in which the payments were received. This view was predicated on the courts' conception of "installment accounting." Since these cases followed accounting concepts instead of the statutory concept of recognition, they would have to be regarded as overruled by the *Wheeler* case, even if §115(l) had not been enacted. And, of course, by the enactment of §115(l) Congress has forbidden the determination of earnings and profits, so far as sales and exchanges are concerned, on any basis other than the statutory concept of recognition.

Conclusion.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. Arthur Platt,
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November, 1947.